Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SJ:POSTU-146099-01
LBBelote

date: JUL 29 2002

to: Dennis Omer, Team Coordinator
Examination, San Jose

from: LAURA B. BELOTE
Attorney (LMSB)

---

subject: Response to [redacted]'s Position Paper
EIN: [redacted]; Tax Years: [redacted], [redacted]

This memorandum responds to your request for assistance. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

The Examination team assigned to examine the [redacted] and [redacted] tax years have requested our advice concerning a position paper given to the team by the taxpayer, [redacted] ("[redacted]"). In the paper, [redacted] addressed the two following issues:

1. Whether [redacted] may rely on Revenue Ruling 78-228 to support its position that property manufactured in the United States and assembled and tested outside the United States by [redacted] is not "export property" as defined in I.R.C. §927.

2. Whether [redacted] is entitled to relief under I.R.C. §7605(b).

Exam has asked for our legal opinion as to whether either of [redacted]'s claims have merit.

CONCLUSIONS

1. Because the definition of manufacturing is different under the DISC and FSC provisions, the taxpayer may not rely upon Rev. Rul. 78-228, which addresses the DISC rules, to support it position that assembly and test operations conducted abroad were not manufacturing for purposes of the FSC rules.

2. [redacted] is not entitled to relief under I.R.C. §7805(b).

BACKGROUND

In [redacted], Central California District Counsel ("CCDC") requested field advice concerning the assembly and testing stages of [redacted]'s [redacted] production for the tax years [redacted], [redacted] and [redacted]. Specifically, CCDC asked whether assembly and test operations performed outside the U.S. on [redacted] contained in a [redacted] (which was fabricated in the U.S.) are "manufacturing," as described in Treas. Reg. §1.927(a)-1T(c). If those operations constituted manufacturing, then the sale of the final [redacted] product did not qualify as export property with the meaning of I.R.C. §927(a)(1). Consequently, [redacted] would not be entitled to certain foreign sales corporation ("FSC") benefits.

In response to CCDC's request for field advice, CC:INTL:Br6 issued a Field Service Advice ("FSA") on January 21, 1997 (cited as 1997 FSA LEXIS 211) which concluded that for the tax years in issue, a threshold level of assembly may qualify as manufacturing. In the Analysis section, the FSA distinguished Rev. Rul. 78-228, upon which the taxpayer relied in support of its position that the assembly and test stages did not constitute manufacturing. Rev. Rul. 78-228 explained why various activities constituted manufacturing under the Domestic International Sales Corporation ("DISC") regulations then in place. The Service observed that the facts and law involved in the ruling were not the same as the facts and law pertinent to the [redacted] case. Accordingly, the Service determined that [redacted] could not rely on Rev. Rul. 78-228 as it was irrelevant with respect to [redacted]'s FSC activities.

The Examination team is currently examining [redacted]'s [redacted] and [redacted] tax years and has again determined that assembly and test operations conducted by [redacted] outside the U.S. on [redacted] are manufacturing. In response, [redacted] has submitted to the Exam team a position paper in which it contends that it is entitled to rely on Rev. Rul. 78-228 to support its position that assembly and test operations abroad were not manufacturing. [redacted] further argues that the FSA discussed above inappropriately

dismissed this ruling, and claims that Subpart F rules and case law should not be determinative in the resolution of a FSC manufacturing issue. Finally, [redacted] asserts that the "retroactive application of a change in position with regard to Rev. Rul. 78-228, an outstanding and unmodified ruling upon which [redacted] has relied, would cause [redacted] significant adverse consequences entitling [redacted] to relief under I.R.C. §7805(b)."

LEGAL ANALYSIS

Rev. Rul. 78-228

[redacted]'s reliance on Rev. Rul. 78-228 ignores the plain language of the FSC provisions of the codes and regulations, as well as case law. Rev. Rul. 78-228 involves rules applicable only to DISCs. The DISC rules were superseded by the FSC/Subpart F regime, effective for transactions occurring after December 31, 1984. As a result of the change in law, the definition of manufacturing changed slightly, but significantly for purposes of this issue analysis. Thus, although the requirements for qualified export property contained in the DISC rules are generally similar to analogous FSC requirements, the two sets of rules contain different definitions for manufacturing.

For DISC purposes, Treas. Reg. §1.993-3(c)(2)(ii), (iii) and (iv) provides three definitions of manufacture. To be considered manufactured under the regulation, either property must have been substantially transformed (§1.993-3(c)(2)(ii)), the activities performed must have been substantial in nature and generally considered to constitute the manufacture or production of property (§1.993-3(c)(2)(iii)), or the conversion costs incurred must account for 20% or more of the costs of goods sold (§1.993-3(c)(2)(iv)). Under the DISC rules, Treas. Reg. §1.993-3(c)(2) provides, for purposes of Treas. Reg. §1.993-3(c)(2)(ii) or (iii), that "manufacture or production of property does not include assembly or packaging operations with respect to property."

Under the FSC/Subpart F regime, property is considered to be manufactured if the property is manufactured or produced, as defined in Treas. Reg. §1.954-3(a)(4). Treas. Reg. §1.927(a)-1T(c)(2). Treas. Reg. §1.954-3(a)(4)(ii) treats property as manufactured if it is substantially transformed. In addition, if purchased property is used as a component part of personal property which is sold, the sale of the property will be treated as the sale of a manufactured product (rather than the sale of component parts) if the operations conducted by the selling corporation in connection with the property purchased and sold

are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Treas. Reg. §1.954-3(a)(4)(iii). A 20 percent conversion test similar to Treas. Reg. §1.993-3(c)(2)(iv) is also included in the regulation.

In contrast to the DISC regulations, Treas, Reg. §1.954-3(a)(4)(iii) provides that packaging, repackaging, labeling, or minor assembly operations will not constitute the manufacture of property for purposes of I.R.C. §954(d)(1). Thus, the FSC provisions use a definition of manufacturing that is different from the definition used in the DISC provisions. While Treas. Reg. §1.993-3(c)(2) expressly excludes assembly of all types from the definition of manufacturing (except in the case of the 20 percent test), the FSC provisions exclude only minor assembly.

The Tax Court has also analyzed whether assembly activities constituted manufacturing under Treas. Reg. §1.954-3. See e.g., Bausch & Lomb, Inc. v. Comm'r., T.C. Memo. 1996-57; Dave Fischbein Manufacturing Co. v. Comm'r., 59 T.C. 338 (1972), Aqv., 1973-2 C.B. 2. See also, Webb Export Corp. v. Comm'r, 91 T.C. 131 (1988). These cases reveal that, for purposes of Treas. Reg. §1.954-3, a threshold level of assembly may qualify as manufacturing. Thus, [redacted]'s reliance on Rev. Rul. 78-228, in the FSC context, is not warranted.

I.R.C. §7805(b)

[redacted] has also argued that the Service has changed its position regarding Rev. Rul. 78-228, and has retroactively applied this change to [redacted]'s detriment. Consequently, [redacted] believes that it is entitled to relief under I.R.C. §7805(b). I.R.C. §7805(b) was intended to be a taxpayer-relief provision by granting the I.R.S. power to avoid inequitable results by applying its regulations and rulings with prospective effect only. In order to be eligible for relief under I.R.C. §7805(b) a taxpayer must show (1) a prior published Service position; (2) detrimental reliance; (3) a subsequent change in the Service's position; and harm to the taxpayer due to the change in the Service's position. Anderson, Clayton & Co. v. United States, 562 F.2d 972, 981 (5th Cir. 1977), cert. denied, 436 U.S. 944 (1978).

Rev. Proc. 89-14 provides guidance concerning standards of publication of revenue rulings and procedures, and is useful in resolving this issue. §7.01(6) of the procedure provides that taxpayers may rely on revenue rulings in determining their own tax treatment until such published revenue rulings have been affected in any way by "subsequent legislation, treaties,

regulations, revenue rulings, revenue procedures or court decisions." §7.01(6) further provides, in part, that each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved. Accordingly, taxpayers should determine whether a revenue ruling or revenue procedure on which they seek to rely has been affected by subsequent legislation, treaties, regulations, revenue rulings, revenue procedures or court decisions.

[redacted] is not entitled to relief under I.R.C. §7805(b) as its reliance on Rev. Rul. 78-228 is misplaced. Rev. Rul. 78-228 does not involve the law applicable to FSCs. Instead, it addresses rules applicable to DISCs. Because the definition of manufacturing is different under the DISC and FSC provisions, we conclude that the taxpayer may not rely upon Rev. Rul. 78-228, which addresses the DISC rules, to support its position that assembly and test operations conducted abroad were not manufacturing for purposes of the FSC rules. Additionally, the specific facts and activities of [redacted] in the tax years [redacted] and [redacted] are different from the facts in Rev. Rul. 78-228. Moreover, the Service did not change the its position regarding Rev. Rul. 78-228; rather, the Service's analysis of [redacted]'s case in the FSA involved a different fact pattern and a different rule. Thus, there was no harm to the taxpayer in this case. We finally note that I.R.C. §7805(b) relief does not extend to all cases in which a taxpayer takes a reasonable but erroneous position that goes unchallenged for many years. It is established law that the Service's acceptance of the erroneous treatment of items in prior taxable years does not preclude the correction of the erroneous treatment in succeeding years. See e.g., Knights of Columbus Counsel v. U.S., 783 F.2d 69 (7th Cir. 1986); Unity Equity Cooperative Exchange v. Commissioner, 481 F.2d 812 (10th Cir. 1973), cert. denied, 414 U.S. 1028 (1973); Harrah's Club v. U.S., 228 Ct. Cl. 650 (1981); Hawkins v. Commissioner, 713 F.2d 347 (8th Cir. 1983).

Please note that we have forwarded a copy of this memorandum to our National Office to ensure that the above analysis is consistent with the National Office position. National Office has reviewed and agreed with the portion of the analysis discussing Rev. Rul. 78-228. We are still waiting National Office response regarding the I.R.C. §7805(b) analysis, and will notify you if the National Office believes that our analysis should be revised as soon as possible.

If you have any questions or concerns, please do not hesitate to contact the undersigned attorney at (408) 817-4694.

Associate Area Counsel
(Large and Mid-Size Business)

By: Laura B. Belote
LAURA B. BELOTE
Attorney (LMSB)